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UNCLAS SECTION 01 OF 04 TAIPEI 002875

SIPDIS

STATE PASS AIT/W AND USTR
STATE FOR EAP/RSP/TC, EAP/EP, EB/IFD/OMA
USTR FOR FREEMAN, WINTER AND WINELAND
USDOC FOR 4420/USFCS/OCEA/EAP/LDROKER
USDOC FOR 3132/USFCS/OIO/EAP/ADAVENPORT
TREASURY FOR OASIA/LMOGHTADER
TREASURY PASS TO OCC/AMCMAHON
TREASURY ALSO PASS TO FEDERAL RESERVE BOARD OF GOVERNORS,
AND SAN FRANCISCO FRB/TCURRAN

E.O. 12958: N/A
TAGS: ECON EFIN PINR TW
SUBJECT: TAIWAN BANK M&A MAY PICK UP STEAM

REF: A. TAIPEI 2131
¶B. TAIPEI 1878

¶1. Summary: Following the failure to privatize Changhwa bank, Taiwan authorities are making measured moves to encourage bank consolidation and proceed with the second-stage of financial reform. While it appears unlikely that the reform plan will achieve its stated benchmarks established in October 2004, progress is being made and there is increasing pressure for banks to actively seek merger and acquisition partners. End Summary.

Second Stage of Financial Reform

¶2. Ref A reports on the failure to consummate the privatization of Changhwa bank. The planned privatization was to be the trigger point to start bank consolidation for the financial reform plan announced by President Chen Shui-bian on October 20, 2004. The plan, referred to as the second-stage of financial reform in banking circles, was developed by the Presidential Economic Advisory Team. Its goal is to increase efficiency in the banking sector and the utilization of banking assets. Currently, the banking industry's rate of return on assets is less than one percent, and the return on equity, according to figures from the first quarter of 2005, has risen to a modest 3.7 percent. The strategy calls for introducing international banking standards into the market and decreasing the number of banks and financial holding companies. The plan established some quite specific benchmarks:

a. Having a state-owned bank sold to and operated by a foreign one by the end of 2005;
b. Reducing state-owned banks from 12 to 6 by the end of this year; and
c. Cutting financial holding companies from 14 to 7 by the end of 2006.

Environment for Banking M&A

¶3. The American Chamber of Commerce held a seminar on May 18 featuring international (Goldman Sachs, Jones & Day and HSBC) and local firms (ChinaTrust Bank) discussing the prospects for banking mergers and acquisitions in Taiwan. The participants noted that there is no shortage of political will at senior levels of the Taiwan government for bank consolidation and that the government wants to see consolidation take place quickly. One banker also suggested that the government's desire for rapid consolidation runs counter to industry preference. He said that merging a weak bank with a sound one would take at least a year and that merging two sound banks would take considerably longer, perhaps three years. While the industry as a whole agrees that consolidation is good for the banking sector and for Taiwan's economy, few, if any, senior bank executives want to be the first one to sell or merge their bank.

¶4. Seminar participants said that it is not hard for the government to realize its goal of bank consolidation because it can quickly merge a number of existing state-owned banks. This process may have already begun with banking circles and press speculation on the expected merger of the International Commercial Bank of China (ICBC) with Chiao Tung Bank. Both of which are operated by state-owned Financial Holding Company Mega Holdings. Other indications of M&A activity include a June 30 resolution by the Taipei Commercial Bank to merge with SinoPac Financial Holding Company; Yuan Da Business Group acquiring Fuhua Financial Holding Company; and Cathay Financial Holding Company announcing June 30 its acquisition of Lucky Bank. (Note: Reftel B reports on another ongoing merger in April of Macoto Bank with Shin Kong. End Note.) The M&A experts, however, called on the government to respect market forces and realize that foreign banks will place a lower value on local M&A targets than will domestic banks. Foreign banks will be unwilling to pay the same price that local banks will, largely because local banks

have an unmet need for additional branch offices. One seminar participant called on the government to make a &good8 bank available for sale to all bidders, suggesting that this would serve as a catalyst for increased M&A in the banking sector. This comment reflected the market's view that the Changhwa sale was flawed because it limited the potential buyers to foreign banks and that Changhwa was not a particularly sound bank.

¶5. Market participants and news reports indicate that Changhwa bank is moving forward to try and recover from the bungled sale to a foreign bank. Current plans call for several sound local banks, as well as private placement funds, to join together and propose a takeover mechanism. Cathay, Fubon and ChinaTrust are reportedly in discussions on how to solve the Changhwa problem.

Background on the Banking Reform Measures

¶6. Motivated by a sharp rise in the rate of nonperforming loans in 2000, Taiwan launched a major effort to improve the quality of its banks in 2001. The NPL rate in 2001 was double the rate in 1997 when the Asian Financial crises erupted. Taiwan Authorities established the Financial Reconstruction Fund (FRF) with a capital base of NT$140 billion to address insolvent financial institutions. The FRF, similar to the Resolution Trust Corporation in the US, has taken over 47 insolvent financial institutions and, eventually, sold them to sound banks. The 47 institutions included the credit departments of 36 farmers associations, nine credit cooperative associations and two banks. In addition, Taiwan authorities offered incentives for financial institutions that lowered NPL ratios below 7% by December 2002 and below 5% by December 2003. Institutions failing to meet the targets would be subject to penalties. Similar carrot and stick measures have been adopted for credit departments of farmers associations and credit cooperative associations. Officials hope that the combination of incentives and penalties will encourage financial institutions to consolidate.

¶7. Taiwan banks, responding to the government's measures, cut their NPL rates by writing off bad debt and selling problem assets to asset management companies. By December 2004, the quantity of non-performing loans fell 64.5% to NT$590.7 billion (US$19 billion) from a peak of NT$1,661.9 billion (US$53.6 billion in March 2002. Average NPL ratios dropped from 11.7% to 3.8%. The rapid write-offs eroded bank profitability, causing banks to post a combined pre-tax loss of NT$104.6 billion (US$3.8 billion) in 2002. By 2004, though, banks returned to profitability and reported combined profits of NT$153.3 billion (US$5 billion).

¶8. Reducing NPLs also eroded capital adequacy rates. Banks compensated for the capital losses by issuing debt (convertible into equity), resulting in total bank debt reaching NT$676.4 billion (US$21.8 billion) in December 2004, four times the level in 2001. The average capital adequacy ratio reached 9.5%, higher than the existing requirement of 8%.

Current Banking Environment

¶9. The current banking environment consists of 48 banks, all with less than a ten percent market share. This number is down from the 53 banks operating in Taiwan at this time last year. Senior officials routinely decry the &overbanking8 situation and call for bank consolidation. Financial Supervisory Commission Chairman Kong Jaw-sheng told AIT/T that his goal is to change Taiwan's banking environment from one of lots of little banks into one of several large banks capable of effectively operating in the regional market.

More Reform Needed & Delivered in 2005

¶10. Even while citing figures indicating that nonperforming loan ratios continue to decline significantly, the FSC's Bureau of Monetary Affairs has been enacting a variety of new rules in 2005 to encourage banks to improve their operations. BOMA has set targets for all banks to meet on rate of NPLs, coverage of bad debts and capital adequacy. As of February 2005 all banks are required to lower NPL rates below 5%, to increase the level of reserves to cover bad loans above 40% and to achieve capital adequacy rates above 10%. Even while the average rates achieved by banks in these three categories are quite good, it is a different story when one looks at individual banks. According to AIT/T analysis of data on bank operations, some 60 percent of banks do not now meet all three of BOMA's basic guidelines listed above. While most banks probably meet one or two of the targets, fewer than half meet all three of the targets.

Carrots...

¶11. Along with announcing the new requirements, BOMA offered some incentives for banks to hit the targets. Among the

incentives for banks that bring NPL ratios below 5% and increase bad debt coverage above 40% are: the ability to introduce new financial products and services; relocate branch offices (except for moving to Taipei and Kaohsiung); install automatic service facilities outside banking offices, and travel to China without applying for a permit. Additional incentives for banks that bring their NPL below 2.5% include establishing offices overseas (including China); replacing a full-service branch office with four limited-service branches; and the ability to offer the following services without going through and application and approval process: investment below statutory ceiling limits, introduction of collective management services for trust funds and introducing mutual funds.

¶12. FSC offers extra incentives in the case of banks that meet the bad debt coverage and capital requirements and bring their NPL rates below 2.5%. Such banks do not need prior permission from BOMA to introduce specified new banking services. This benefit will help sound banks to quickly offer new services in the marketplace. Foreign banks enjoy this benefit as well as local ones.

¶13. The FRF has helped eight credit coops transform themselves into banks. BOMA allows these eight new banks and community-level financial institutions to relocate branch offices provided their NPL rate is below 5%.

Credit Coop Incentives

¶14. BOMA is also trying to encourage community-level Credit Cooperative Associations (CCA) to improve their quality. CCAs may only operate in a county or city where no other CCAs exist. An existing CCA may expand to two neighboring counties or cities if its capital adequacy exceeds 12%, its NPL rate is below 1%, and its bad debt coverage is 100%. A CCA may expand to a single neighboring county or city if is capital adequacy is 10%, its NPL is 2% and its bad debt coverage exceeds 40%.

And Sticks

¶15. BOMA also has some penalties in hand for banks which fail to meet the new targets. If a bank's NPL ratio exceeds 5%, it will be subject to the following:

-- Restrictions on establishing branches;
-- Limits on compensation paid to Board Members;
-- Limits on dividend payouts to shareholders;
-- Restrictions on investments in non-financial firms; and
-- Limits on loans or loan guaranties to related persons.

If the NPL ratio exceeds 15%, a bank faces the following penalties:

-- Restrictions on providing banking services to high-risk clients;
-- Restrictions on offering high interest rates for deposits;
-- BOMA may reduce the number of branches; and
-- BOMA may require removal of Board members and/or bank managers. (Note: On June 26, the FSC announced that it has ordered the Hualien Business Bank to dismiss the majority of its Board Members for making improper loans to business and personal associates. End Note.)

Comment

¶16. In the wake of the failure to sell off Changhwa bank as originally planned, the government continues to make measured moves to encourage bank consolidation. The market is evaluating a wealth of M&A opportunities. It seems highly unlikely that the first benchmark of the financial reform plan -- a foreign bank operating a state-owned bank this year -- will be met. Foreign banks are unwilling to pay domestic prices for a financial institution. The second benchmark -- cutting back to 6 state-owned banks this year -- is clearly within reach. Changhwa Bank will probably be taken over by a consortium of domestic banks in the near future and, as suggested by the AmCham seminar participants, the government is moving to merge ICBC and Chiao Tung Bank. Over the next several months Taiwan's smaller and weaker banks will come under increasing pressure to consolidate with other institutions. It may not happen as quickly as some in the government would like, but some bank consolidation appears to be a real possibility in 2005. The third benchmark -- halving the number of Financial Holding Companies -- is not due until next year and is unlikely to be addressed until then.
KEEGAN